U.S. Senate Republican Policy Committee

Larry E. Craig, Chairman
Jade West, Staff Director

Legislative Notice

Editor, Judy Gorman Prinkey

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H.R. 8 – Death Tax Elimination Act of 2000

Calendar No. 608

Passed by the House of Representatives on June 9, 2000, and on June 19 was placed directly on the Senate Calendar.

NOTEWORTHY

- A cloture vote on the motion to proceed to H.R. 8 is slated for Tuesday, July 11, 2000. Once on the bill, it is anticipated the Majority Leader will file a cloture petition on the bill itself. That cloture vote likely will occur on Thursday, July 13.

- The House adopted H.R. 8 on June 9, 2000, by a vote of 279-136, which is greater than the two-thirds necessary to override the promised presidential veto. Sixty-five Democrats joined the Republican majority to support the bill.

- H.R. 8 would repeal the estate, gift, and generation-skipping taxes — so-called death taxes — over a 10-year period. Fully implemented, H.R. 8 would ensure that the death of a property owner would no longer be considered a taxable event.

- Legislation similar to H.R. 8, sponsored by Senator Kyl, has been cosponsored by nine Senate Democrats — Kerrey, Breaux, Robb, Lincoln, Wyden, Landrieu, Cleland, Bayh, and Murray.

- Despite the fact that the United States imposes the highest estate tax levies in the developed world, these taxes raise only between 1 and 2 percent of overall federal revenues.

- Studies by the Joint Economic Committee, the National Center for Policy Analysis, the Heritage Foundation, the American Council for Capital Formation, the Institute for Policy Innovation, the Cato Institute, and others all indicate the federal estate tax imposes significant costs on the economy and family-owned businesses, resulting in lower economic growth, job creation, and the destruction of family businesses.

HIGHLIGHTS

Repeal of the federal estate tax is another key component of Republican efforts to reduce the excess tax burden faced by working families while making the overall tax code less complicated and burdensome both to taxpayers and the American economy. Support for repealing the estate tax has focused on the following points:

Popular: Perhaps counter-intuitively, repealing the estate tax is one of the more populist tax cuts considered by Congress this session. Not only do studies show the estate tax has a dramatic impact on the ability of family-owned farms and businesses to survive and create job opportunities, survey after survey has revealed that 70 to 80 percent of Americans in general are critical of the tax and supportive of its repeal. This broad-based support is evident in the number of states that have acted to repeal their state-level estate taxes. Since 1980, more than 20 states have elected to repeal their estate taxes.

Pro Environment: According to the Competitive Enterprise Institute, over 75 percent of the species listed under the Endangered Species Act rely on private land for some or all of their habitat. The estate tax imposes a significant burden on these private property owners to retain and preserve their lands. For owners of forest land, for example, the tax establishes a barrier to sound management of those forests and actually encourages deforestation. It has been estimated that 25,000 acres of prime forest land is converted to other uses in Washington state each year, primarily to raise money to pay the estate tax.

Pro Family Business: According to the book, "The Millionaire Next Door," self-employed individuals are four times as likely to accumulate $1 million in assets over their lifetime than those people who work for someone else. Moreover, self-employed individuals make up two-thirds of those Americans whose estates are worth more than $1 million. As a tax on accumulated wealth, the estate tax is a direct attack on these individuals.

Meanwhile, the Small Business Administration Office of Advocacy estimates that seven out of ten family-owned businesses fail to survive from one generation to the next. While this failure rate can be attributed to many factors, the federal estate tax is cited by family business owners as a major obstacle blocking a successful transition. For example, a report by the Family Enterprise Institute found that 60 percent of black business owners believe the estate tax makes the survival of their business significantly more difficult or impossible.

The estate tax also hampers the ability of family-owned businesses to compete against larger corporations. In testimony before the House Ways and Means Committee, a lumberyard owner from New Jersey spoke of incurring up to $1 million in costs associated with preserving the family business pending the death of his grandmother. At the same time the family was incurring these costs, the business was also competing against a new Home Depot store that had moved into the area. Home Depot is not subject to the estate tax.

Pro-Job: A survey of 365 businesses in upstate New York found an estimated 14 jobs per business were lost in direct consequence of the costs associated with estate tax planning and payment. That amounts to more than 5,000 jobs lost in a limited geographical area. Nationally, the *Wall Street Journal* reported that an estimated 200,000 jobs would be created or preserved if the estate tax were eliminated.

Pro Tax Reform: While the debate between national sales tax and flat tax advocates continues, all tax reform proponents agree that the current tax code contains too many layers and excessive marginal rates that inhibit savings, economic growth, and job creation. By repealing the highest remaining federal tax rates, several hundred pages of federal statutes, and a direct tax on savings and investment, H.R. 8 represents a dramatic step toward overall tax reform.

BACKGROUND

Under current law, the estate tax is assessed against estates valued at $675,000 and above. While this exemption is scheduled to increase to $1 million by 2006, it is still well below its historic levels. For example, the exemption provided to estates when the estate tax was first adopted in 1916 was the equivalent of $9 million in inflation-adjusted dollars. To put that in perspective, over 50 percent of all estate tax revenues today are collected from estates smaller than $5 million. Those estates would not have been subject to the tax in 1916.

The marginal rates assessed against estates are the highest in the tax code — 55 percent for estates larger than $3 million plus a 5-percent surcharge assessed against larger estates. These rates are second only to Japan for those countries that charge an estate tax. The Japanese tax, however, only applies against estates much larger than those taxed in the United States. Thus, the United States has the dubious honor of imposing the most onerous estate tax in the developed world.

H.R. 8 would eliminate the estate tax over a 10-year period, at which time the United States would join Canada, China, and several other countries that have already repealed their respective estate taxes. In the time between now and the eventual repeal, H.R. 8 provides significant estate tax relief by reducing the marginal rates and transforming the current unified tax credit into a tax exemption.

True Exemption

The benefits of the shift from a unified tax credit to an exemption are less than obvious at first glance. The unified credit effectively exempts $675,000 this year and will rise to $1 million by 2006. However, as a tax credit, it is applied after the total tax has been calculated, not before. On the other hand, an exemption is applied against the value of an estate before the tax is calculated.

This shift reduces the marginal tax rates applied to smaller estates. For example, under the current credit, an estate valued at $1 million would face marginal up to rates of 39 percent and be subject to a total tax of $125,250. With the exemption, the top marginal rate applied against the estate is now 32 percent and the total tax owed is $96,300 – a 23-percent tax savings. As estates get larger, the value of the shift to an exemption declines as a percent of the total tax owed.

Step Up In What?

One of the critical aspects of H.R. 8 is its treatment of the step-up in basis available under current law. The bill retains the step-up in basis for up to $1.3 million in assets ($3 million for spouses) transferred. Estates larger than $1.3 million (or $3 million for spouses) can choose which assets receive the new basis. This treatment was first proposed in the Kyl/Kerrey estate-tax-repeal legislation (S.1128) and is important for smaller estates that are exempt from taxation under current law.

For example, if your father purchased a farm for $100,000 in 1960, $100,000 is the basis. If he sells the farm in 2000 for $1 million, the capital gain is the farm's sales price less the farm's basis, or $900,000. Your father would owe $180,000 in capital gains taxes for the sale (20 percent of $900,000).

When estates are transferred following the death of the owner, their assets receive a new basis equal to their valuation at the time of the owner's death. In the above case, if your father willed his farm to you in 2000, it would get a new basis of $1 million. If you decide to sell the farm five years from now, the capital gain would equal the sales price less the new basis of $1 million. The step-up in basis represents a tax benefit of $180,000 (assuming we still have a capital gains tax five years from now).

Twenty years ago, assets transferred following the death of their owner did not receive a new basis. The old basis would "carry over" to the new owners. These assets were subject first to the estate tax, and then to capital gains taxes based upon their original basis — the price your father paid for the farm. The combination of double taxation and paper-work headaches (some farms have been owned by the same families for centuries) was extremely unpopular, and Congress changed the tax code to its current approach.

More recently, critics of the death tax repeal effort have observed that repealing the estate tax without addressing the basis issue would allow the capital gains of large estates to go untaxed indefinitely. On the other hand, eliminating the step-up for all estates would result in a tax increase for estates below $675,000.

By retaining a modified stepped-up basis for assets up to a certain size, H.R. 8 ensures that smaller estates avoid a tax increase while making the assets of larger estates subject to capital gains taxes when and if they are sold.

BILL PROVISIONS

H.R. 8 would reduce federal estate and gift tax collections over the next nine years, followed by full repeal in year ten. The bill includes a number of provisions that will affect estate tax collections, including:

Rate Reductions: Prior to repeal of the estate, gift, and generation-skipping transfer taxes in 2010, H.R. 8 would reduce the estate tax rates across-the-board. Rates would be reduced to no less than the lowest individual income tax rate for unmarried individuals. Specifically, the bill provides the following:

- **2001**: Eliminates the 5-percent "surcharge" levied against estates to capture the tax benefit of graduated rates and eliminates the top rate of 55 percent;

- **2002**: Reduces the top estate-tax rate to 50 percent;

- **2003-2006**: Reduces all estate tax rates — from 18 percent to 50 percent — by one percentage point per year. Under this provision, the top estate-tax rate in 2006 would be 46 percent.

- **2007**: Reduces all estate tax rates by 1.5 percent. The top estate-tax rate is now 44.5 percent.

- **2008-2009**: Reduces all estate tax rates by 2 percentage points. Top rate is now down to 42.5 percent.

Unified Exemption: Under current law, estates subject to the death tax are eligible for a unified tax credit, which has the effect of exempting from taxation estates valued up to $675,000. This exemption is scheduled to rise to $1 million by 2006.

H.R. 8 would change the unified tax credit into a unified tax exemption, equal to $675,000 in 2001 and growing to $1 million by 2006. The shift from the credit to exemption has the effect of reducing the estate tax rates on smaller taxable estates by a considerable amount. For example, under current law, an estate valued just above $675,000 is subject to a marginal tax rate of 37 percent. With a unified exemption, the marginal rate falls to 18 percent.

Step-Up Basis: The bill would replace the current unlimited step up in basis with a limited step up for transferred assets up to a certain amount. Currently, all assets transferred following the death of their owner receive a step-up in basis [See Background]. H.R. 8 would replace this universal step-up with a step-up limited to $1.3 million of the total assets transferred. For assets transferred to a spouse, the limit would be $3 million.

ADMINISTRATION POSITION

President Clinton has promised to veto H.R. 8 in its current form [see Statement of Administration Policy, June 8, 2000]. However, the President has indicated a willingness to sign legislation which falls short of full estate tax repeal.

COST

The Joint Committee on Taxation estimates H.R. 8 would reduce revenues by $5 billion in 2002 and by $28 billion over the next five years.

POSSIBLE AMENDMENTS

Democrat Substitute: An alternative similar to the substitute offered in the House of Representatives to reduce the marginal estate tax rates while increasing the exemption currently offered to Qualified Family Businesses from $1.3 million to $2 million. [The amendment, offered by Representative Rangel (D-NY) failed by a vote of 196-222.]

Staff contact: Brian Reardon, 224-2946